## Solution 2.1

In order for financial statements to be reliable, they should:

- not include material error or bias;
- be a faithful representation;
- show the substance rather than the legal form of the transaction;
- be neutral;
- be prudent (but not to the extent that reserves become hidden); and
- be complete (within the confines of materiality and cost).

## Solution 2.2

- The framework is not an International Financial Reporting Standard [paragraph 2 of framework].
- Faithful representation forms part of the discussion of reliable information (qualitative characteristic) of useful information as addressed in the framework.
- IAS 1 p13 states that fair presentation requires faithful representation of transactions and elements as defined in the framework.
- As a result, IAS 1, p13, therefore requires a user to incorporate the principles set out in the framework (although it is not an IFRS) as well as the definitions of the elements, so as to achieve fair presentation.

## Solution 2.3

The qualitative characteristics are:
- Understandability;
- Comparability.
- Reliability; and
- Relevance;

*Understandability*
Since entities are allowed to use a variety of measurement models to report their financial information, understandability is impaired. For example, IAS 16 (Property, plant and equipment) allows the cost model or the revaluation model to be used for different classes of assets: users may not understand how different classes of property, plant and equipment can be measured using different measurement models. Conversely, IAS 39 (Financial instruments) allows the fair value model to be used for both 'financial assets at fair value through profit and loss' and 'financial assets available for sale': users may not necessarily understand how financial assets that are classified differently are measured in the same way.

*Comparability*
Comparability amongst similar entities is impaired by permitting choice between measurement models and further detracts from their understandability. For example, two similar entities may choose different models (i.e. one may choose to measure their non-current assets at cost less accumulated depreciation (cost model) and another entity may choose to measure them at fair value less accumulated depreciation (revaluation model)).

*Reliability*
With regard to IAS 16 (Property, plant and equipment), for example, the cost model may be argued to be more reliable than the revaluation model. On the other hand, it is unlikely to provide relevant values for the statement of financial position as the depreciated cost is unlikely to have any relevance to its true value.

*Relevance*
The fair value and revaluation models are more likely to produce relevant values, but may be criticized as being unreliable in the absence of active markets. The fair value and revaluation models aid comparability as similar assets with differing historical costs could be reported as the same value in the statement of financial position. It may, however, be noted that fair value accounting can also detract from comparability in extremely volatile markets.

**Conclusion:**
It can be seen that it is difficult to successfully meet all four qualitative characteristics.

## Solution 2.4

### a) Users and their information needs

- *Investors*. The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.
- *Employees*. Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.
- *Lenders*. Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.
- *Suppliers* and other trade creditors. Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer.
- *Customers*. Customers have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent on, the entity.
- *Governments and their agencies*. Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to regulate the activities of entities, determine taxation policies and as the basis for national income and similar statistics.
- *Public*. Entities affect members of the public in a variety of ways. For example, entities may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities.

### b) Relationship between users and other investors

While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

## Solution 2.5

**Statement of fact**

The credit entry represents equity.

**Explanation**

**Introduction:**
An account with a credit balance is normally a liability, income or equity. The definitions of each of these elements will now be discussed.

**Definition of a liability and discussion thereof**
- a present obligation of the entity,
- as a result of past events,
- the settlement of which is expected to result in an outflow of economic benefits.

There is an essential difference between an equity participant and a financier. An equity participant (shareholder) invests money in a company for an indefinite period of time. He is considered to be a part owner, who never expects to be refunded the capital contributed. Instead, the shareholder hopes for dividend distributions and growth in the value of his share certificates through the success of the company. The financier (e.g. bank), on the other hand, *lends* money to the company for a defined period of time, meaning that as soon as the finance is received there is an obligation to repay this amount. *(This discussion was not required).*

Although there is a past event – the issue of shares – this event, in itself, does not create an associated present obligation. The transaction in question involves equity participants and accordingly, there exists no obligation to repay the amount of C120 000. By default, there will be no related settlements resulting in the outflow of future economic benefits. Both the share capital and the share premium are obviously not liabilities.

**Definition of income and discussion thereof**
- an increase in future economic benefits during the accounting period,
- in the form of inflows or enhancements of assets or decreases in liabilities,
- resulting in an increase in equity other than through contributions from equity participants.

There has been an inflow of assets during the period: an amount of C 120 000 in cash upon the issue of shares. But, the definition specifically excludes contributions from equity participants: therefore both the share capital and share premium cannot be considered to be income since it represents a contribution from equity participants.

**Definition of equity and discussion thereof**
- the residual interests in assets,
- after deducting all liabilities.

Since the transaction creates an asset of C120 000 (cash in bank) and does not create a liability at all (as explained in the discussion above), the residual interest resulting from the transaction is a net asset of C120 000 with the result that both the share capital and the share premium should therefore be treated as equity.

***Please note:***
*The required specifically referred to a 'discussion of the relevant definitions' whereas no reference was made to the discussion of the recognition criteria – this is the reason why the recognition criteria were not discussed here. Had the required not specified 'definitions' but rather required a discussion in terms of the 'Framework' in general, then a discussion of* ***both*** *definitions* ***and*** *recognition criteria would have been required.*

## Solution 2.6

**Definitions and recognition criteria:**

*Income definition:*

- There must be an increase in economic benefits during the accounting period
- in the form of inflows or the enhancement of an asset/s; or decrease in liabilities
- resulting in an increase in equity
- other than contributions from equity participants.

*Liability definition:*

- There must be a present obligation of the entity
- as a result of a past event
- the settlement of which is expected to result in an outflow of future economic benefits.

*Recognition criteria for a liability:*

A liability may only be recognised in the financial statements if:
- it is probable that future economic benefits will flow to/from the entity; and
- the element has a cost or value that can be reliably measured.

*Recognition criteria for income:*

Income may only be recognised in the financial statements if:
- there is a probable increase in future economic benefits through either an increase in assets or decrease in liabilities; and
- this increase can be measured reliably.

**Discussion:**

The bookkeeper is incorrect in the accounting treatment of the receipt since it does not meet the definition of 'income':

- although the cash received from the tenant is an increase in economic benefits during the accounting period (December 20X3); and
- the receipt has increased Hazyview Mall Ltd's assets (bank);
- there has been a simultaneous increase in liabilities since Hazyview Mall Ltd has an obligation to provide the tenant with occupation for January 20X4 or refund the C65 000;
- with the result that there has been no increase in equity (assets: 65 000 – liabilities: 65 000)

The receipt of C65 000 meets the definition of a liability:

- Hazyview Mall Ltd has a present obligation to provide the tenant occupation in January 20X4 or refund the C65 000;
- as a result of a past event, being the receipt of the C65 000;
- the settlement of which is expected to result in future economic benefits flowing from Hazyview Mall Ltd in the form of occupation rights or a refund of the cash receievd.

## Solution 2.6 continued …

Both the recognition criteria for the recognition of a liability have been met in that:

- the outflow of future economic benefits is probable (the tenant is a long-standing tenant and, as such, it is not expected that Hazyview Mall Ltd would fail to provide occupation to the tenant in January 20X4 or would cancel the lease agreement and not refund the cash)
- the value can be reliably measured (C65 000).

**Conclusion:**

The bookkeeper must treat the receipt as a current liability in the financial statements of Hazyview Mall Ltd as at 31 December 20X3.

The correcting journal entry is as follows:

| *31 December 20X3:* | **Debit** | **Credit** |
|---|---|---|
| Rental income | 65 000 | |
| Rental income received in advance (L) | | 65 000 |
| *Rent income received in advance* | | |

## Solution 2.7

The accountant has debited an expense and credited a liability. Both of these elements will now be discussed in terms of the arguments presented by the accountant.

**Definition of a liability**
- a present obligation of the entity,
- arising from past events,
- the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

**Recognition criteria for a liability**
- it must be probable that the future economic benefits will flow from the entity,
- the item must have a cost that can be reliably measured.

**Definition of an expense**
- Decreases in economic benefits,
- during the accounting period,
- in the form of outflows or depletions of assets or incurrence of liabilities,
- that result in decreases in equity, other than those relating to distribution to equity participants.

**Recognition criteria for an expense**
An expense may only be recognised in the financial statements if:
- there is a probable decrease in future economic benefits through either an decrease in assets or an increase in liabilities; and
- this decrease can be measured reliably.

**Discussion of the definition of a liability**
- Although a possible outflow of economic benefits would result in the event of a theft or other calamity, this outflow is not expected since:
- no past event has occurred: neither an insurance contract has been signed (requiring the payment of insurance premiums) nor has a calamity occurred (requiring a repair or replacement); and thus
- there is no present obligation (for an obligation to be a *present* obligation, there has to be a past event). Furthermore, there is no obligation as the company is not obliged, (legally or otherwise), to repair or replace any items damaged. An obligation derives from either a legal obligation or a constructive obligation (e.g. public expectations created through a public announcement). Neither a legal nor a constructive obligation exists here since there is simply an internal management decision that can obviously be rescinded.

**Discussion of the recognition criteria for a liability**
- It can be argued that the cost of C480 000 is reliably measured, as it represents the best estimate of the insurance expense based on past experience. Although the liability has been estimated based on past insurance contributions, the actual claims have historically been significantly less than the insurance premiums. This means that the C480 000 may be slightly overestimated but still acceptable on the grounds that this is a prudent approach.
- The outflow of economic benefits is, however, not probable since no past event has occurred; the outflow is only possible at this stage.

## Solution 2.7 continued …

**Discussion of the definition of an expense**

- Although the possible loss represents a decrease in future economic benefits (e.g. through the destruction of a machine),
- this has not yet occurred and is therefore not 'during the accounting period'; and
- there is no outflow during the period (e.g. payment of insurance premiums), no depletion of assets (e.g. destruction of a machine) and no liability incurred (e.g. signing of an insurance contract or contract for repairs); and therefore
- there is no decrease in equity and therefore there is no expense.

**Discussion of the recognition criteria for an expense**

- Although there is an amount that may have been reliably measured (C480 000),
- there is no change to either assets or liabilities, and therefore there is no decrease in equity (future economic benefits) and therefore the recognition criteria are not met.

**Conclusion**

Since there is no liability (meeting neither the definition nor the recognition criteria), there can also be no expense and therefore the journal entry should be reversed.

***Please note:***

*The required specifically referred to a discussion in terms of the 'Framework': for this reason, the discussion involves **both** definitions **and** recognition criteria.*

## Solution 2.8

**Treatment of brands as an asset**

**Definition of an asset:**
- resource controlled by the entity,
- as a result of past events,
- from which future economic benefits are expected to flow.

**Discusssion of the definition**
- Control - the brand is a resource that is controlled by the entity since it has been purchased by the entity and control will therefore be supported by legal documents.
- Past event - the past event is the signing of the purchase documents.
- Future economic benefits - future economic benefits are expected through increased sales resulting from the ownership of the brand.

The purchased brands therefore meet the definition of an asset.

**Recognition criteria and discussion thereof:**
- Cost / value must be reliably measured: since the brand is purchased, the cost is reliably measurable (C1 500 000) in terms of purchase documentation.
- Future economic benefits must be probable: Although the sales have doubled, which may be indicative of future trends, (probable future economic benefits), what portion of these future economic benefits stem from the C1 500 000 brand and what portion from other expenditure, such as an effective sales team, is difficult to measure reliably.

**Conclusion:**
Assuming that the increase in sales can be attributed to the new brand, and to a sufficient extent, it would suggest that there are probable future economic benefits that are expected from the brand. In such a case, the C1 500 000 should be capitalised and amortised against the future income

***Please note:***
*Depending on time allocation in a test or examination, it may be prudent to also discuss the definition and recognition criteria of an expense as well (this was not discussed here since the required was not clear that both the asset and expense definitions and recognition criteria needed to be discussed and obviously a mark allocation was unavailable to guide the extent of the answer).*

## Solution 2.9

**Introduction:**
The incentive payments represent a debit, therefore the treatment as an asset or an expense should be discussed.

**Definition of an asset:**
- resource controlled by the entity,
- as a result past events,
- from which future economic benefits are expected to flow.

**Recognition criteria for an asset:**
- it must be probable that the future economic benefits will flow to the entity,
- the item must have a cost that can be reliably measured.

**Discussion of the asset:**
The contract acquired through the payment of the incentive:
- is a resource (right to receive cash from the members),
- which is controlled by the entity (through a signed contract)
- from a past event (the signing of the contract)
- from which future economic benefits are expected to flow over the next 2 years (through membership fees).

- There is a probable inflow of future economic benefits since the customer is bound by a legal contract to pay monthly fees.
- The amount of the fees are stipulated in the contract and are therefore reliably measurable.

The definition and recognition criteria of an asset are therefore met.

**Definition of an expense:**
It represents
- a decrease in economic benefits,
- during the accounting period,
- in the form of outflows (through a decrease in assets or an increase in liabilities),
- that result in decrease in equity (other than through distributions to equity participants).

**Recognition criteria for an expense:**
- there must be a probable decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen
- that can be measured reliably.

**Discussion of the expense:**
- The amount of the incentive payment is reliably measured since it would be stipulated in terms of the contract;
- The payment of the incentive payment is made in the accounting period, on which date
- There is a decrease in assets (bank);
- There is therefore a decrease in equity and therefore the payment could be expensed.

## Solution 2.9 continued …

**Conclusion:**
The incentive payment meets both the definition of an asset and the definition of an expense (and related recognition criteria).

Since, however, the contract is a 2-year contract, thus meaning that income is expected over 2 years, the cost of the incentive payment should be recognised when the revenue is recognised. This requires the treatment of the payment as an asset that is amortised over the 2-year period.

The amortisation should not be over a 10-year period since this is based on research into European trends and not South African trends in which the loyalty of South Africans might prove vastly different:

- the research in Europe covers only a five year period, so the asset should be amortised over a period not longer than 5 years, otherwise the concept of prudence is not met (assuming that the results of the European research are equally applicable in South Africa);
- the club has only recently entered into the South African market and may not survive so to keep an asset in the statement of financial position for 10 years is not prudent (since the probability of future economic benefits becomes questionable);
- it is more prudent to amortise the asset faster (over 2-years) based on the uncertainties mentioned above;
- since the asset will be decreased over two years, the definition of an expense will be met in each of these two years – the expense will be reliably measured based on the amount by which the asset has decreased.

Note: if the customer is able to cancel the contract relatively easily, then the future economic benefits from signing up a customer are no longer probable (recognition criteria not met) and it would therefore be more prudent to treat the full incentive payment as an expense in the first year.

## Solution 2.10

**Definition of a liability**

- A present obligation of the entity
- Arising from past events
- The settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

**Discussion of a liability**

- There is no past event at 31 March 20X4 since the event that would lead to an obligation is the declaration, which happened afterwards (13 April 20X4).
- There can be no present obligation at 31 March 20X4 since there is no past event.
- The settlement of the dividend will result in an outflow of economic benefits when the dividend payment is made.

Since the definition is not met in its entirety, a liability may not be recognized at the end of the financial year (31 March 20X4).

**Definition of an expense**

- A decrease in economic benefits during the accounting period
- in the form of outflows or depletions of assets or incurrences of liabilities
- that result in decreases in equity, other than distributions to equity participants.

**Discussion of an expense**

- At 31 March 20X4, there has been no increase in liabilities (see discussion above) or decrease in assets (no dividend payment was made on or before 31 March 20X4) and therefore there has been no decrease in economic benefits during the period.
- A dividend declaration should, in any event, never be included as an expense in the statement of comprehensive income as it represents a distribution to equity participants, which is expressly excluded from the definition of an expense.

**Conclusion:**

The journal entry made in the books of the 31 March 20X4 must be reversed as follows:

| *31 March 20X4* | **Debit** | **Credit** |
|---|---|---|
| Dividend payable (liability) | xxx | |
| Dividend (expense) | | xxx |
| *Reversal of previous dividend journal entry: no obligation at 31 March X4 and incorrect allocation to an expense account* | | |

The following dividend journal entry should then be processed on 13 April 20X4 instead.

| *13 April 20X4* | **Debit** | **Credit** |
|---|---|---|
| Dividend (equity distribution) | xxx | |
| Dividend payable (liability) | | xxx |
| *Dividend declared on 13 April 20X4: 0.15 x number of issued shares* | | |

## Solution 2.11

**Definition of an asset**

- resource controlled by the entity,
- as a result of past events,
- from which future economic benefits are expected to flow.

The river is a resource acquired by the entity from past events (the purchase of the farm) from which future economic benefits are expected to flow (the river promotes growth of the crops which in turn yield profits - cost savings on the water bill is also a future economic benefit to consider). There may be doubt as to whether the farm controls the river, since the river may run dry due to drought (which cannot be controlled by the farm) or due to a farm damming or polluting it upstream, etcetera. All these factors are effectively out of the control of the farmer.

**Recognition criteria for an asset**

- the cost should be reliably measurable,
- the future economic benefits should be probable

It may be argued that the future economic benefits that will flow from the use of the river are probable (e.g. cost savings in not having to pay the local council for water; and profits from the sale of crops) but the cost or value of the river cannot be reliably measured since it was purchased as part of the farm (as opposed to purchasing it as a separate item).

**Conclusion**
Although the river may meet the definition of an asset, (assuming there is sufficient control over the river) it may not be included as an asset in the statement of financial position since it does not meet the recognition criteria.

*An alternative would be to revalue the entire land and buildings and in so doing include the value of the river in the land and buildings amount (i.e. the river will then be included in the valuation of the farm but would not be disclosed as a separate item due to the difficulty in measuring it as a separate item).*

## Solution 2.12

The Framework requires financial statements to reflect substance and economic reality of transactions over legal form. The issue in question is whether the inventory should be included as an asset in Minutemin's financial statements or in the manufacturer's financial statements.

The Framework's definition of an asset and the recognition criteria need to be applied to the situation.

**Definition of an asset:**
An asset is
- a resource, controlled by the entity,
- as a result of a past event,
- from which future economic benefits are expected to flow to the entity.

**Discussion of the asset definition:**
- Minutemin pays insurance in respect of the photocopy machines which indicates the risks and rewards of ownership have passed. There has never been an instance where the machines were returned to the manufacturer. All indications are that the photocopiers are controlled by the company.
- The past event is Minutemin taking possession of the machines.
- Future economic benefits are expected to flow from the sale of the machines and sale of photocopies.

All the elements of the definition of an asset are therefore met.

**Recognition criteria for an asset:**
The recognition criteria require an asset to be recognized when:
- it is probable that future economic benefits will flow to the entity and
- the asset has a cost or value that can be measured reliably.

**Discussion of the asset's recognition criteria:**
- It is probable that Minutemin will receive economic benefits from the sale of the inventory as inventory has never been returned to the manufacturer.
- The cost of the photocopiers can be reliably measured as it is determined when the photocopier is received by Minutemin.

The recognition criteria are both met.

Since both the asset definition and related recognition criteria are met, Minutemin must recognize the inventory as an asset in its books.

The journal entries would be as follows: (not required)

| | Debit | Credit |
|---|---|---|
| Inventory | 30 000 | |
| Bank | | 3000 |
| Accounts payable | | 27 000 |
| *Purchase of inventory and payment of deposit* | | |
| Accounts payable | 27 000 | |
| Bank | | 27 000 |
| *Payment of balance owing upon sale of inventory* | | |
| Cost of sales | 30 000 | |
| Inventory | | 30 000 |
| *Inventory is expensed as it is sold* | | |

## Solution 2.13

**Introduction**
The main concern is whether the item should be treated as an asset or an expense depending on whether it meets the specific definitions and recognition criteria.

**Treatment as an asset**

**Definition of an asset**

- Resource under control of the company
- Resulting from a past event
- From which future economic benefits are expected to flow to the company

**Applying the asset definition to the plantation**

- It is under the control of the company. The plantation is on company land and is being developed and maintained by the company.
- The past event is the development of the plantation.
- Future economic benefits: If the trees are harvested and the wood is sold, economic benefits will flow to the company. It can therefore be assumed that the plantation has been developed (and the costs incurred) with expected future economic benefits in mind.

**Recognition criteria for an asset:**

- The inflow of future economic benefits must be probable.
- The item must have a cost/value that can be measured with reliability.

**Application of the recognition criteria to the plantation:**

- As the period prior to expectation of the benefits is quite long, there is some uncertainty involved in the probability of the inflow of future economic benefits (e.g. drought, fire, market after 10 years, etc).
- The cost of developing the plantation can in this case be determined with accuracy since all costs have been provided for including both the original purchase cost of the land and the plantation costs to date.

**Definition of an expense**

- Expenses are decreases in economic benefits
- during the accounting period
- in the form of outflows or depletions of assets or incurrences of liabilities
- that result in decreases in equity,
- other than those relating to distributions to equity participants.

## Solution 2.13 continued …

**Applying the expense definition to the plantation**

- In this case the cost to develop and maintain the plantation must be paid and can be seen as the outflow of an economic benefit through the depletion of an asset, being the bank account or an increase in liabilities if the amounts have not yet been paid.
- These outflows of economic benefits have all occurred before 31 December 20X2 and the outflows are therefore said to have occurred 'during the accounting period'.
- Since there has either been a decrease in assets or an increase in liabilities (or a decrease in assets *and* an increase in liabilities, assuming some amounts have not yet been paid), there will be a decrease in equity.

Since none of these outflows represent distributions to equity participants the outflows meet the definition of an expense.

**Recognition criteria for an expense:**

- There must be a probable decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen
- that can be measured reliably.

**Applying the recognition criteria to the plantation:**

- The decrease in future economic benefits is probable since the asset has been reduced already (e.g. cash in bank was reduced to make related payments);
- The C1,3 million is supported by documentation of payments and invoices and is therefore reliably measurable.

Since the recognition criteria relating to the expense are both met, the expense should be recognised.

**Conclusion:**

Assuming that the uncertainty regarding the probable inflow of future economic benefits is material, the definition of an asset is met but its recognition criteria are not. Conversely both the definition and related recognition criteria of an expense are met and therefore the journal entry showing the C1.3 million as an expense is correct. No adjustment is required.

**Alternative conclusion:**

Assuming that the uncertainty regarding the probable inflow of future economic benefits is not material, the costs can be said to comply with the definition and recognition criteria of an asset. The development and maintenance costs are integral to the sustainability of the asset. The capitalisation is justified based on the fact that these costs will generate future income. Without spending on development and maintenance the company may not realise the expected incomes (20% on costs), and although a long time will pass before the trees will result in any income, it is fair to assume that they were planted with the intention of earning a return over and above the costs incurred and thus the future economic benefits will be earned.

Therefore there are sufficient reasons for treating the costs as an asset.

## Solution 2.14

**a) Definitions:**

***i) Liability:***
- Present obligation of the entity
- As a result of a past event
- The settlement of which will result in an outflow of future economic benefits.

***ii) Equity:***
- The net increase in assets after deducting liabilities

***iii) Expense:***
- A decrease in economic benefits
- During the accounting period
- Through an increase in liabilities or decrease in assets
- Resulting in a decrease in equity, other than a distribution to equity participants.

**b) Discussion: Recognition**

***i) Recognition of the initial issue of preference shares:***

*Liability:*
- Since Keeptrying Ltd's preference shares are compulsorily redeemable, they represent a present obligation of the entity.
- The past event is the issue of these shares on 1 January 20X3.
- The settlement of this obligation will result in an outflow of cash of C420 000 (in respect of the par value of the shares: C300 000, the premium: C30 000 and the annual dividends: C30 000 x 3 years = C90 000).

The preference shares therefore meet the definition of a liability.

*Equity:*
- Since bank (an asset) increased and
- preference shares (a liability) increased,
- there is no impact on equity.

The preference shares therefore have no impact on equity.

## Solution 2.14 continued …

**b) Discussion: Recognition continued …**

***ii) Recognition of the redemption of preference shares:***

*Expense:*

- A decrease in economic benefits: cash outflow
- During the accounting periods: 20X5
- Through an increase in liabilities or decrease in assets: decrease in bank
- Resulting in a decrease **in equity, other than a distribution to equity participants:**
  - Since the issue of the preference shares represents a liability, none of the payments to the preference shareholders represent distributions to equity participants.
  - Since the par value of the shares and premium on redemption are both committed to on the date that the preference shares are issued and are thus recognised as liabilities, the repayment of each represents a decrease in assets (decrease in the bank account) and a decrease in this preference share liability balance, with the result that there is no impact on the equity. These repayments are therefore not expenses.
  - The C300 000 paid is a settlement of the original liability
  - The C30 000 paid is a settlement of the premium that accrued over the 3 years.
  - Both the above payments thus decrease liabilities and, at the same time, decrease the assets (bank) with the result that the payments do not represent expenses.

The preference shares therefore have no impact on expenses.

**c) Calculation: Measurement**

- Liabilities should be recognised at the present value of the future obligation (future obligation is C420 000):
  - C318 762 at 31 December 20X4.

- The liability balance may be calculated as follows:

| Effective interest rate table | Interest at 12,937% | Bank | Premium accrued | Preference share liability |
|---|---|---|---|---|
| | | | | 300,000 |
| 31/12/20X3 | 38,811 | -30,000 | 8,811 | 308,811 |
| | | | 8,811 | |
| 31/12/20X4 | 39,951 | -30,000 | 9,951 | 318,762 |
| | | | 18,762 | |
| The rest of this table was not required: | | | | |
| 31/12/20X5 | 41,238 | -30,000 | 11,238 | 330,000 |
| | | | 30,000 | |
| 31/12/20X5 | | -330,000 | -30,000 | 0 |
| | | | 0 | |
| | 120,000 | -420,000 | | |

## Solution 2.14 continued …

**d) Journals:**

| | Debit | Credit |
|---|---|---|
| **1 January 20X4** | | |
| Retained earnings | 8 811 | |
| Premium accrued | | 8 811 |
| *Correction: preference dividend & premium recognised as interest expense* | | |
| **1 January 20X4** | | |
| Preference share (equity) | 300 000 | |
| Preference share (liability) | | 300 000 |
| *Correction: recognition of preference shares as a liability* | | |
| **31 December 20X4** | | |
| Finance charges | 39 951 | |
| Preference dividend | | 30 000 |
| Premium accrued | | 9 951 |
| *Correction: preference dividend & premium recognised as interest expense* | | |
| **31 December 20X4** | | |
| Preference share (liability) | 318 762 | |
| Current portion of preference share (liability) | | 318 762 |
| *Correction: recognition of preference shares as a liability* | | |

*Assuming that it was possible for the company to process correcting journals in the 20X3 records, the following correcting journal would be processed in 20X3 (below) instead of the correcting journal processed on 1 January 20X4 (above):*

| | Debit | Credit |
|---|---|---|
| **31 December 20X3** | | |
| Finance charges | 38 811 | |
| Preference dividend | | 30 000 |
| Premium accrued | | 8 811 |
| *Correction: preference dividend & premium recognised as interest expense* | | |

## Solution 2.15

**Introduction:**

The issue surrounds whether an increase in the value of an asset should be recognised as income or recognised directly as an increase in equity.

**Definitions:**

*Equity is defined as:*
- The residual interest in the assets of the entity
- After deducting its liabilities.

*Income is defined as:*
- An increase in economic benefits
- During the accounting period
- That increases equity through either
- An increase in assets or a decrease in liabilities
- Other than through a contribution from equity participants.

**Discussion:**

*Discussion of income definition:*
- The value of the plant was re-measured to fair value and resulted in an increase in assets in the trial balance.
- Since the value of assets increased but liabilities remained the same, this resulted in an increase in equity.
- Although the revaluation occurred during the accounting period, this increase in economic benefits was not actually realised during the accounting period since it has not been sold.
- Although this item meets the framework definition of income, it is excluded from profit measurement. (IAS 1, paragraph 80)

*Discussion of equity definition:*
- Since the plant (an asset) has increased in value and
- since there is no concomitant increase in liabilities,
- equity will have increased.

**Conclusion:**

Equity has increased and the income definition has been met. However, the increase in the asset's value (since it is obviously not a liability in any way) is recognised directly in equity because it is excluded from the measurement of profit (IAS 1, paragraph 80).

IAS 1, paragraph 96 requires that the statement of changes in equity to disclose:
- profit or loss;
- income and expenses recognised directly in equity; and
- the total of the above two items.

This disclosure is necessary since it is important to consider all items of income and expense in assessing changes in an entity's financial position between two reporting dates.

## Solution 2.16

**Asset definition:**
- a resource controlled by the entity
- as a result of past events and
- from which future economic benefits are expected to flow to the entity.

**Recognition criteria for an asset:**
- the future economic benefits expected to flow to the entity must be probable; and
- the asset must have a cost or value that can be measured reliably.

**Discussion:**
- The increased customer awareness created through the advertising promotion could be argued to be a resource.
- The decision to undertake advertising promotions is within the control of the entity.
- There is a past event since the promotion took place before 31 December 20X8.
- The future economic benefits are expected to flow in through increased future sales.

- The cost can be reliably measured as the C2 000 000 has already been spent.
- The issue relates to the uncertainty of the *probability* of the future benefits. The company cannot control how the public will react to the advertising i.e. whether they will react positively, which will result in an increase in sales, or whether they will react negatively, which will result in a decrease in sales, or whether they are indifferent , which will result in no change to sales. This lack of control over the flow of future economic benefits and the difficulty in linking any future increase in the inflow of economic benefits directly to the advertising means that the probability criteria needed for recognition is not met.

So although the definition of an asset is met, the accountant may not capitalize the amount.

## Solution 2.16 continued …

**Expense definition:**
- decreases in economic benefits
- during the accounting period
- in the form of outflows or depletions of assets or incurrence of liabilities
- that result in decreases in equity, other than those relating to distributions to equity participants.

**Recognition criteria for an expense:**
- Recognised in the statement of comprehensive income when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen
- that can be measured reliably.

**Discussion:**
- The advertising expense has been paid and can be seen as the outflow of an economic benefit through the depletion of an asset (bank account).
- The expenditure was approved by the board and paid prior to the year end; hence it occurs 'during the accounting period'
- The payment does not represent a distribution to equity participants and should be recognised as an expense.

The cost therefore meets the definition of an expense.

- The cost of the item can be reliably measured as there is an amount of C2 000 000 that has been paid.
- There is a decrease in future economic benefits as there has been a decrease in the asset bank.

The recognition criteria have also been met and therefore the expense should be recognised.

**Conclusion:**
The entire amount must be expensed in the financial statements for the year ended 31 December 20X8.